[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 6410
(THE PENSION EQUITY TAX ACT OF 1982)

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON JUNE 8, 1982

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a hearing on June 8, 1982, on H.R. 6410, the Pension Equity Tax Act of 1982 (introduced by Mr. Rangel). The bill would make changes in a number of Code provisions relating to pension and other employee benefit plans.

The first part of the pamphlet is a summary of the bill. The second part is background information relating to the bill. The third part is a more detailed description of the bill, including present law, explanation of provisions, and effective dates.

I. SUMMARY OF THE BILL

Overall limits on contributions and benefits

Present law limits 1982 contributions on behalf of an employee to a qualified profit-sharing or other defined contribution plan to the lesser of 25 percent of compensation or $45,475. Annual benefits payable under a qualified defined benefit pension plan are limited to the lesser of 100 percent of compensation or $136,425 for life, beginning at age 55. The limits (set at $25,000 and $75,000 in 1974) are automatically adjusted for cost-of-living increases.

The bill would reduce the overall dollar limits to $30,000 and $90,000, repeal the automatic cost-of-living adjustment for these amounts, and require that the $90,000 benefit limit be reduced if benefits commence before age 65.

The bill would also reduce the aggregate limit applicable to an employee who is covered by both a defined contribution plan and a defined benefit pension plan of the same employer and would apply limits to post-retirement medical benefits.

Loans to plan participants

The bill would retain the present-law rules which treats a loan to a self-employed individual from a qualified plan, or a loan from an IRA to the IRA's owner, as a distribution and would extend the rules to certain key employees covered by qualified plans of corporate employers. In addition, a loan under a tax-sheltered annuity contract, or from amounts deferred under a qualified cash or deferred profit-sharing plan, would be treated as a distribution under the bill.

Integration with social security

Present law prohibits a qualified plan from discriminating in favor of highly compensated employees by providing them contributions or benefits which are a higher percentage of pay than contributions or benefits provided rank-and-file employees. In measuring plan contributions or benefits for an employee, a portion of the social security retirement benefit can be taken into account as if provided under the plan. This permits the employer to reduce plan contributions or benefits for the employee, so that the plan supplements rather than duplicates, the employee's social security retirement benefits.

The bill would continue to allow an employer to reduce plan contributions or benefits on account of employer-provided social security benefits, but generally would limit the reduction to the actual cost of the employee's social security benefits which is borne by the employer.

Special rules applicable to plans covering self-employed individuals and plans of professional service corporations

The bill would raise from $15,000 to $30,000 the annual deduction limit for contributions to an H.R. 10 (Keogh) plan on behalf of a self-employed individual.

In addition, the bill would extend to all H.R. 10 plans certain of the special qualification rules that now apply to H.R. 10 plans benefiting owner-employees (sole proprietors and partners whose partnership interest exceeds 10 percent). The bill would also apply the rules for H.R. 10 plans to qualified plans of certain professional service corporations.

Statutory fringe benefit plans

The bill would provide uniform antidiscrimination standards for statutory fringe benefit plans (employer plans providing accident, health, group term life insurance, group legal, van pooling, educational assistance, and dependent care). Under the bill, if a statutory fringe benefit plan discriminates in favor of key employees, the cost of the benefits provided to key employees under the plan would be allocated to them and included in their income.

Estate tax exclusion for retirement savings

The bill would limit to $500,000 the present-law estate tax exclusion for amounts payable under qualified plans, tax-sheltered annuities, and IRAs.

II. BACKGROUND

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law (sec. 401(a)), then (1) a trust under the plan is generally exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution are accorded special long-term capital gain and 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement account (IRA) or another qualified plan, and (4) certain estate and gift tax exclusions are provided.

Under a tax-sheltered annuity program, amounts paid by an educational institution or by an eligible tax-exempt organization to purchase an annuity contract for an employee are excluded from the employee's income, subject to certain limits (sec. 403(b)). Excludable contributions to custodial accounts investing in stock of a regulated investment company (*e.g.*, a mutual fund) are also permitted. Distributions under tax-sheltered annuities or custodial accounts generally are includible in gross income. However, lump sum distributions may be rolled over, tax-free, to another such annuity contract or account or to an IRA. In addition, certain estate tax and gift tax exclusions apply.

If an individual retirement account or individual retirement annuity (IRA) qualifies as a simplified employee pension (SEP), the annual IRA deduction (generally the lesser of $2,000 or 100 percent of compensation) is increased by the lesser of $15,000 or 15 percent of compensation. The increase in the deduction limit applies only to employer contributions (sec. 408(k)). Except in the case of certain correcting distributions, all distributions from SEPs are includible in gross income unless rolled over to another IRA. Amounts held in a SEP can qualify for exclusions under the estate tax and gift tax rules for IRAs.

III. DESCRIPTION OF THE BILL

A. Overall Limits on Contributions and Benefits

(Sec. 2 of the Bill and Sec. 415 of the Code)

Present Law

In order to limit the extent to which individuals can use tax-favored arrangements to provide for retirement, the plan qualification rules (sec. 415) provide overall limits on contributions and benefits under qualified pension, etc., plans, tax-sheltered annuities, and simplified employee pensions (SEPs). The overall limits apply to contributions and benefits provided an individual under all qualified plans, tax-sheltered annuities, and SEPs maintained by an employer or by certain related employers.

Under a profit-sharing or other defined contribution plan,[1] the qualification rules provide an overall limit on the annual addition with respect to each plan participant (sec. 415(c)). Generally, the annual addition (consisting of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants) is limited to the lesser of (1) 25 percent of compensation for the year, or (2) $25,000 adjusted for cost-of-living increases (CPI) since 1974. The limit for 1982 is $45,475. The defined contribution plan limit also applies to tax-sheltered annuities and SEPs.

Under a defined benefit pension plan [2] the annual benefit derived from employer contributions is subject to an overall limit of the lesser of (1) 100 percent of average compensation, or (2) $75,000, adjusted for cost-of-living increases (CPI) since 1974 (sec. 415(b)). The limit for 1982 is $136,425. The annual benefit is the equivalent of a retirement benefit for the life of the employee, beginning at age 55 or later, and without regard to certain survivor benefits or nonretirement benefits. If the retirement benefit begins before age 55, the annual limitation ($136,425 for 1982) is actuarially reduced to the equivalent of the benefit limit at age 55.

If an employee participates in a defined contribution plan and a defined benefit plan maintained by the same employer, the fraction of the separate limits used by each plan is computed and the sum of the fractions is subject to an overall limit of 1.4 under the qualifica-

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[1] A defined contribution plan is one under which each participant's benefit is based solely on the balance of the participant's account consisting of contributions, income, gain, expenses, losses, and forfeitures allocated from the accounts of other participants (*e.g.*, a profit-sharing plan).

[2] A defined benefit pension plan specifies a participant's benefit independently of an account for contributions, etc. (*e.g.*, an annual benefit of two percent of average pay for each year of employee service).

tion rules (sec. 415(e)). For example, if the annual additions under the defined contribution plan is 5/10ths of the defined contribution limit, then the annual benefit earned under the defined benefit plan could not exceed 9/10ths of the defined benefit limit for the year.

Explanation of Provision

The bill would make several changes to the overall limits on contributions and benefits. The maximum dollar limit on annual additions under defined contribution plans would be decreased from $45,475 to $30,000, and maximum dollar limit on annual benefits under defined benefit plans would be decreased from $136,425 to $90,000. In addition, these limits would no longer be subject to automatic cost-of-living inrceases. For participants covered by both a defined contribution plan and a defined benefit plan of the same employer, the limit on the sum of the fractions of the separate limits used by each plan would be reduced from 1.4 to 1.0.

Under the bill, if the retirement benefit under a defined benefit plan begins before age 65, the $90,000 limitation would be reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 65.

The bill also provides that post-retirement medical benefits provided with respect to a plan participant (including post-retirement benefits provided a spouse or dependent of a retiree) would be taken into account in determining whether plan benefits exceed the $90,000 annual limit. Under regulations prescribed by the Secretary of the Treasury, the aggregate amount of post-retirement medical benefits payable with respect to a retiree could not exceed the amount which would be required to provide an annuity for the life of the retiree equal to the $90,000 limit less the annual benefit derived from employer contributions and payable to the retiree under the plan.

Effective Dates

For existing plans, the provisions would apply to years ending after December 31, 1983. For plans not in existence on the date of enactment, the provision would apply to years ending after that date.

B. Loans to Plan Participants

(Sec. 3 of the Bill and Sec. 72 of the Code)

Present Law

Qualified pension, etc., plans

A qualified pension, etc., plan generally is permitted to make a loan to a plan participant if certain requirements are met. Generally, the loan must bear a reasonable rate of interest, be adequately secured, provide a reasonable repayment schedule, and be made available on a basis which does not discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 4975(d)). However, a qualified plan benefitting a self-employed individual (an H.R. 10 plan) is not permitted to lend to an owner-employee (a sole proprietor or a partner whose partnership interest exceeds 10 percent), and a plan of an electing small business corporation (a subchapter S corporation) is not permitted to lend to a shareholder-employee (an employee owning more than 5 percent of the corporation's stock). Also, if a self-employed individual (whether or not an owner-employee) participating in an H.R. 10 plan borrows from the plan or uses an interest in the plan as security for a loan, the transaction is treated as a plan distribution and the usual income tax rules for distributions apply (sec. 72(m)).

IRAs

Under present law, if an individual borrows from an IRA or uses amounts in an IRA as security for a loan, the transaction is treated as a distribution and the usual income tax rules for IRA distributions apply (secs. 72(m) and 408(e)). Rules corresponding to the IRA provisions apply with respect to loans from accumulated deductible employee contributions under an employer's plan and to the use of the accumulated contributions as security for a loan (sec. 72(o)).[3]

Qualified cash or deferred arrangements

Present law (sec. 401(k)) provides that an employee participating in a qualified cash or deferred arrangement under a profit-sharing or stock bonus plan is not required to include in income an employer contribution to the plan merely because the employee could have elected to receive the amount in cash. The cash or deferred arrangement must form a part of a profit-sharing or stock bonus plan which satisfies the usual plan qualification rules. In addition, the cash or deferred arrangement must satisfy special requirements with respect

[3] For taxable years beginning after 1981, an employee is allowed a deduction for voluntary contributions to a plan if certain requirements are met (sec. 219). The annual deduction is limited to the lesser of $2,000 or 100 percent of the employee's compensation, and is in lieu of the deduction allowed for contributions to an IRA.

to amounts attributable to the elective deferrals.[4] An employee may borrow amounts attributable to the employee's electric deferrals, subject to the usual loan rules for qualified plans.

Explanation of Provision

The bill retains the present-law loan rules which apply with respect to loans to self-employed individuals under H.R. 10 plans, qualified plans of subchapter S corporations, IRA's and accumulated deductible employee contributions. The bill would extend these rules to loans to (1) certain key employees under qualified plans, (2) tax sheltered annuities, and (3) qualified cash or deferred arrangements.

Under the bill, if a key employee receives a loan from a qualified plan, or uses an interest in the plan as security for a loan, the amount received or pledged would be treated as a distribution for income tax purposes. Key employees generally would include employees (1) who are officers, (2) who have at least a 5-percent ownership interest in the employer, or (3) who are among the highest paid 15 percent of the employer's employees. An employee would be considered an officer or as owning a 5-percent interest in the employer if the employee was an officer or owned such an interest at any time during the 12-month period ending on the date of the loan or other transaction.

Under the bill, an employee would be considered as owning a 5-percent interest in the employer if the employee owned 5 percent of the employer's outstanding stock or stock possessing 5 percent of the total combined voting power of all stock of the employer. An employee would also be treated as owning stock owned by certain members of the employee's family or, in certain cases, by partnerships, estates, trusts, or corporations in which the employee has an interest.

Under the loan rules, an employee would be considered as among the highest paid 15 percent of the employer's employees, if (1) the employee is included within that group at the time of the transaction (determined by taking into account current rates of compensation), or (2) the employee was included within that group for the calendar year preceding the calendar year in which the transaction occurs (determined by taking into account the total compensation of each employee for the previous calendar year).

The bill also provides that any employee who elects to defer amounts pursuant to a qualified cash or deferred arrangement would be treated as a key employee with respect to amounts attributable to the elective deferrals. Also, any employee for whom an employer purchases a tax-sheltered annuity contract would be considered a key employee with respect to the contract.

Effective Date

The provision would apply to loans, assignments, and pledges made after May 19, 1982. For this purpose, an existing loan which is renegotiated, extended, renewed or revised after May 19, 1982, would be treated as being made after that date (*i.e.*, as if made on the date of the renegotiation, extension, renewal or revision).

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[4] In general, the special rules for cash or deferred arrangements (1) impose special nondiscrimination rules with respect to the elective deferrals, (2) require that all amounts contributed pursuant to the employee's election are nonforfeitable, and (3) impose certain limits on distributions of plan benefits attributable to the elective deferrals.

C. Integration With Social Security

(Sec. 4 of the Bill and Sec. 401 of the Code)

Present Law

In general

Under the qualification rules, a pension, etc., plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated by providing them contributions or benefits which are a higher percentage of non-deferred pay than the contributions or benefits provided for other employees covered by the plan (sec. 401(a) (4) and (5)). A plan can qualify if either contributions under the plan or benefits under the plan satisfy the nondiscrimination rules.

Integration of defined benefit pension plans

Under present law, in determining whether pension plan benefits, as a percentage of non-deferred pay, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits paid for by the employer may be taken into account. For this purpose, social security benefits mean old age, survivors, and disability insurance (OASDI) benefits provided under the social security system. If these social security benefits and the employer-provided benefits under the plan, when added together, do not provide an aggregate pension which is a higher percentage of pay for highly compensated employees than for other employees, the benefits under the plan are considered not to discriminate in favor of highly compensated employees.

A pension plan which satisfies the antidiscrimination rule by taking employer-provided social security benefits into account is said to "integrate." Two basic approaches to integration of defined benefit plans have been developed—(1) the "offset" approach, and (2) the "excess" approach. Rules for integrating under these two approaches are set forth in Rev. Rul. 71–446, 1971–2 C.B. 187.

(1) Offset plans

A pension plan which integrates under the offset approach is referred to as an offset plan. An offset plan initially provides each employee with an annual pension benefit which (as a percentage of pay) does not discriminate in favor of highly compensated employees. For each employee, this initial benefit is then reduced, or offset, by the employer-provided portion of that employee's social security benefits to arrive at the actual pension benefit under the plan.

The Internal Revenue Service has determined that the value of employer-provided social security benefits is equal to 83⅓ percent of the annual primary insurance amount (PIA) to which an employee is entitled under social security. Consequently, an offset plan could inte-

grate its benefits with social security by providing each employee an annual benefit of, for example, 50 percent of pay offset by 83⅓ percent of the employee's PIA.

(2) Excess plans

A pension plan which integrates under the excess approach is referred to as an excess plan. The excess approach recognizes that social security provides benefits based on only a certain portion of an employee's earnings. An excess plan is designed to provide benefits (or added benefits) based on the portion of an employee's earnings "in excess" of the earnings on which social security benefits are provided. An excess plan integrates if it provides benefits based on earnings not covered by social security which, as a percentage of pay, do not exceed the employer-provided portion of social security benefits, as a percentage of pay.

The Internal Revenue Service has determined that the employer-provided portion of benefits under social security averages 37½ percent of the average maximum pay on which social security benefits are based. Consequently, for an employee retiring at age 65 in 1982, an excess plan will integrate if it provides benefits at the rate of 37½ percent of pay in excess of $11,004 (approximately the highest average annual wage upon which social security benefits can be based for such an employee), although it provides no benefits with respect to the first $11,004 of pay.

Integration of profit-sharing, etc., plans

Profit-sharing plans, stock bonus plans, and pension plans which specify a fixed rate of employer contributions (as a percentage of pay) on behalf of an employee do not provide specified benefit formulas. Rather, they provide for contributions to be allocated to and accumulated in a separate account for each employee. Accordingly, such plans are integrated by taking into account the assumed cost of employer-provided benefits under social security. Specifically, the plan is integrated by reducing contributions to the plan with respect to the portion of an employee's pay subject to the social security tax.

The Internal Revenue Service has determined that the employer's cost of providing social security benefits is 7 percent of pay subject to the tax (the social security taxable wage base). For 1982, the taxable wage base is $32,400. Accordingly, a profit-sharing plan could provide contributions of 7 percent of 1982 pay in excess of $32,400 and no contributions for 1982 with respect to the first $32,400 of pay. If a plan provides for contributions in excess of 7 percent with respect to pay above the social security taxable wage base, similar contributions would be required with respect to pay up to the wage base. For example, if a plan provides for 1982 contributions of 10 percent (7 percent plus 3 percent) of pay in excess of $32,400, it will integrate only if it provides for 1982 contributions of at least 3 percent for the first $32,400 of pay.

For 1982, the employer's actual tax rate with respect to OASDI benefits under social security is 5.4 percent of the first $32,400 of pay.

Explanation of Provisions

Integration of defined benefit pension plans

The bill would revise the social security integration rules for defined benefit pension plans to permit an employee's annual pension benefit to be reduced by no more than an amount equal to the annual benefit which could be purchased with the aggregate OASDI taxes actually paid by the employer on behalf of the employee. Under the bill, the Secretary of the Treasury is to prescribe regulations for converting the aggregate social security taxes paid by an employer to an equivalent annual pension benefit. These rules would provide for compounding the annual employer OASDI taxes at an appropriate interest rate.

The bill also provides an alternative "safe-harbor" rule for defined benefit pension plans. Under this rule, a plan would be considered properly integrated with social security if (1) the rate of contributions or benefits for pay in excess of $30,000 but less than $60,000 is not more than twice the rate for pay up to $30,000, and (2) the rate for pay in excess of $60,000 is not greater than the rate for pay up to $30,000. Thus, under the alternative safe-harbor rule, a plan could provide a simplified benefit formula which need not take into account actual OASDI taxes paid by the employer on behalf of individual employees.

Integration of defined contribution plans

With respect to profit-sharing and other defined contribution plans, the bill would permit an employer to reduce plan contributions on behalf of an employee by no more than an amount equal to the employee's taxable wage base multiplied by the actual OASDI tax rate. Thus, if the bill's provisions were applicable for 1982, a profit-sharing plan could provide contributions of 5.4 percent of 1982 pay in excess of $32,400 and no contributions for 1982 with respect to the first $32,400 of pay. Similarly, if a plan provided for 1982 contributions of 10 percent (5.4 percent plus 4.6 percent) of pay in excess of $32,400, it would integrate only if it provided for 1982 contributions of at least 4.6 percent with respect to the first $32,400 of pay.

Effective Dates

Under the bill, the new social security integration rules for defined contribution plans would apply to plan years ending after December 31, 1983. For defined benefit pension plans, the new rules would apply with respect to employees who become plan participants after December 31, 1983.

D. Special Rules Applicable to Plans Covering Self-Employed Individuals and Plans of Professional Service Corporations

(Secs. 5 and 6 of the Bill and Secs. 72, 219, 401, 404, 405, and 1379 of the Code)

Present Law

Plans for self-employed individuals

A pension or profit-sharing plan is a qualified plan only if it is established by an employer for the exclusive benefit of employees or their beneficiaries. For this purpose, a sole proprietor is considered both an employee and the employer, and a partnership is considered the employer of each partner.

A qualified plan which benefits a self-employed individual (a sole proprietor or partner) is referred to as an "H.R. 10 plan" or "Keogh plan" and is subject to special rules which are in addition to the other qualification requirements under the Code. These special rules include limits on the contributions and benefits which can be provided for a self-employed individual and also limits on the amount of an employee's compensation which can be taken into account under the plan's contribution or benefit formula. The same or corresponding limits also apply to qualified plans of subchapter S corporations and to simplified employee pensions (SEPs). These limits are generally lower than the overall limits on contributions and benefits applicable with respect to all employees under qualified plans (described above in part III.A.).

Limits on contributions and benefits

Under a qualified profit-sharing or other defined contribution H.R. 10 plan, annual deductible contributions on behalf of a self-employed individual generally are limited to the lesser of $15,000 or 15 percent of net earnings from self-employment (sec. 404(e)). Under a qualified defined benefit H.R. 10 pension plan, the annual benefit accruals for a self-employed individual are limited by a special schedule designed to permit the accrual of an annual pension benefit no greater than that which could be provided by the accumulated annual contributions on behalf of a self-employed individual permitted under a defined contribution H.R. 10 plan (sec. 401(j)).

A qualified pension or profit-sharing plan maintained by an electing small business corporation (a subchapter S corporation) is subject to special limitations corresponding to those for H.R. 10 plans. Under a qualified defined contribution plan of a subchapter S corporation, annual employer contributions on behalf of a shareholder-employee (an employee who owns more than five percent of employer stock) in excess of the annual deduction limit (the lesser of $15,000 or 15 percent of compensation) are includible in the income of the

shareholder employee (sec. 1379(b)). Under a qualified defined benefit pension plan of a subchapter S corporation, benefits are limited under the same schedule that applies to a defined benefit H.R. 10 pension plan.

If an individual retirement account or individual retirement annuity qualifies as a simplified employee pension (SEP), present law increases the annual IRA deduction limit by the lesser of $15,000 or 15 percent of compensation (sec. 408(j)). The increased deduction limit for a SEP applies only to employer contributions.

Limit on includible compensation

Under the additional qualification rules for H.R. 10 plans, plans of subchapter S corporations, and SEPs, only the first $200,000 of an employee's compensation may be taken into account under the plan (sec. 401(a)(17)).

If a defined contribution H.R. 10 plan or SEP takes into account compensation in excess of $100,000, contributions on behalf of a common law employee must be made at a rate not less than 7.5 percent of the employee's compensation. A corresponding rule, requiring a minimum annual benefit accrual for each common law employee, applies with respect to a defined benefit H.R. 10 pension plan under which compensation in excess of $100,000 is taken into account. These same rules apply to a defined contribution or defined benefit plan of a subchapter S corporation. However, the amount actually contributed or the benefit actually accruing for a participant may be less if the plan is integrated with social security.

Special tax-qualification rules for plans benefitting owner-employees

In addition to prescribing tax-qualification requirements generally applicable to all plans, present law requires that if an H.R. 10 plan benefits an owner-employee (a sole proprietor or a partner whose partnership interest exceeds 10 percent), the plan must meet special standards. The special standards include rules relating to (1) coverage, (2) vesting, (3) distributions, (4) integration with social security, (5) employee contributions, (6) plan trustees, and (7) employers under common control. These rules for an H.R. 10 plan benefitting an owner-employee generally require expanded coverage and faster vesting for rank-and-file employees. They also impose limitations with respect to an owner-employee which do not apply to a shareholder-employee under a plan of a corporate employer or to a partner under an H.R. 10 plan whose partnership does not exceed 10 percent.

Coverage standards

In general

The qualification rules (sec. 410(b)) require that a plan cover employees in general rather than merely the employer's top-ranking employees. A plan generally satisfies the present-law coverage rule if (1) it benefits a classification of employees that does not discriminate in favor of employees who are officers, shareholders or highly compensated, or (2) it benefits a significant part of the employer's work force. A plan can meet the second coverage test if (1) it benefits at least 70 percent of all employees, or (2) it benefits at least 80 per-

cent of the employees eligible to benefit under the plan and at least 70 percent of all employees are eligible.

Special H.R. 10 rules

If an H.R. 10 plan benefits an owner-employee, the qualification rules generally require that the plan benefit all employees with at least three years of service with the employer (sec. 401(d)). However, contributions and benefits may not be provided for an owner-employee under an H.R. 10 plan unless the owner-employee consents to being included under the plan.

Vesting standards

In general

To insure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment, the qualification rules generally require that a plan meet one of three alternative minimum vesting schedules (sec. 411). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) to varying degrees upon completion of specified periods of service with an employer.

Under one of the schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting begins at 25 percent after completion of five years of service and increases gradually to 100 percent after completion of 15 years of service. The third schedule takes both age and service into account, but in any event requires 50-percent vesting after 10 years of service and an additional 10-percent vesting each year thereafter until 100-percent vesting is attained after 15 years of service.

Benefits or contributions under a qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated. Because turnover among rank-and-file employees tends to be higher than turnover for officers, etc., it has been recognized that rapid vesting may be necessary to prevent discriminatory forfeitures by the rank-and-file in favor of officers, etc. Under present law (sec. 411(d)(1)), a plan is not required to provide a vesting schedule faster than that required under the minimum vesting standards unless (1) there has been a pattern of discriminatory abuse under the plan (such as a dismissal of employees before their benefits vest), or (2) there has been, or there is reason to believe there will be, a discriminatory accrual of benefits or a discriminatory pattern of forfeitures.

Special H.R. 10 rules

If an H.R. 10 plan benefits an owner-employee, the tax-qualification rules (sec. 401(d)) require that an employee's rights to benefits derived from employer contributions under the plan are nonforfeitable at the time the contributions are paid (*i.e.*, the plan must provide full and immediate vesting).

Distributions of plan benefits

In general

Under the qualification rules, unless an employee otherwise elects, the payment of plan benefits generally must begin no later than 60

days after the end of the plan year in which the employee attains the normal retirement age under the plan (or age 65, if earlier). The payment of benefits may be deferred beyond normal retirement age (or age 65), if the employee has not yet separated from the employer's service or has not yet completed 10 years of plan participation (sec. 401(a)(14)).

Benefits under a qualified plan must be for the primary benefit of an employee rather than the employee's beneficiaries. Accordingly, benefits generally must be payable to the employee at such a rate that more than 50 percent of the total benefits for the employee are payable to the employee over the employee's life expectancy. However, in any case, payments may be made over the joint life expectancy of the employee and the employee's spouse.

A qualified pension plan generally may not distribute plan benefits before (1) the employee retires or otherwise separates from the service of the employer, (2) the employee becomes disabled, or (3) the plan terminates.

Special H.R. 10 rules

Under additional qualification rules for H.R. 10 plans, the payment of benefits to an owner-employee must begin not later than the taxable year in which the owner-employee attains age 70½ (sec. 401(a)(9)). The payment of benefits to a plan participant who is not an owner-employee may be delayed beyond the taxable year in which the participant attains age 70½, if the participant has not yet retired. Benefits under an H.R. 10 plan must be paid ratably over the life of the employee (or the joint lives of the employee and the employee's spouse), or over a period not extending beyond the employee's life expectancy (or the joint life expectancy of the employee and the employee's spouse).

Under the qualification rules, an H.R. 10 plan generally must provide that no benefits will be paid to an owner-employee before the owner-employee attains age 59½ or is disabled (sec. 401(d)(4)). However, the plan is not precluded from distributing to an owner-employee an amount not in excess of the voluntary employee contributions made by the owner-employee to the plan.

If an owner-employee receives a distribution from an H.R. 10 plan prior to attaining age 59½ or becoming disabled, the amount of the distribution includible in gross income is subject to an additional 10-percent income tax (sec. 72(m)(5)). In addition, unless the distribution is made on account of termination of the plan, no contributions may be made to an H.R. 10 plan on behalf of the owner-employee for the five taxable years following the taxable year of the distribution (sec. 401(d)(5)).

Integration with social security

In general

Under the rules permitting integration of a pension, etc., plan with social security, an employee's plan benefits may be reduced by taking into account employer-provided social security benefits. The general rules for integrating a plan of a corporate employer, or an H.R. 10 plan which does not benefit an owner-employee, with social security are described above in part III. C.

Special H.R. 10 rules

H.R. 10 plans generally are defined contribution plans. Under a defined contribution H.R. 10 plan which benefits an owner-employee, annual contributions for an employee may be reduced by the tax imposed on the employer under the Federal Insurance Contributions Act (FICA) with respect to the employee's wages for the year, if (1) the limit on plan contributions for the owner-employee is reduced by the self-employment tax imposed on the owner-employee, and (2) not more than one-third of the deductible contributions to the plan for the year are made on behalf of owner-employees (sec. 401(d)(6)). For 1982, the FICA tax imposed on an employer with respect to an employee's wages is equal to 5.4 percent of the first $32,400 of such wages. The tax on self-employment income is equal to 8.05 percent of the first $32,400 of such income.

No integration with social security is permitted under a defined benefit H.R. 10 plan which covers an owner-employee (sec. 401(j)).

Employee contributions

In general

A qualified plan may provide for contributions by the employer, the employees, or both. In many cases, the employee contributions are mandatory (*i.e.*, required as a condition of employment, a condition of participation in the plan, or a condition of obtaining additional employer-derived benefits). In other cases, employee contributions are voluntary, and the amount, within limits, is left to the discretion of the employee. A plan can provide for both mandatory and voluntary employee contributions.[5]

Contributions under a qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated. Because highly compensated employees may be more able than rank-and-file employees to contribute to a plan, the nondiscrimination rule requires that employee contributions, whether mandatory or voluntary, be subject to certain limits.[6]

Voluntary employee contributions generally may not exceed 10 percent of the employee's compensation. The limit is applied on an aggregate basis (*i.e.*, with respect to an employee's compensation for all years of plan participation). Deductible employee contributions under the plan are not taken into account for purposes of the limitation on voluntary employee contributions.

The Internal Revenue Service has held that mandatory employee contributions may cause prohibited discrimination if they result in precluding participation by lower paid employees (*i.e.*, where the contributions are required as a condition of plan participation) or in disproportionately low benefits for such employees (*i.e.*, where the

[5] For taxable years beginning after 1981, an employee is allowed a deduction for voluntary contributions to a plan if certain requirements are met (sec. 219). The annual deduction is limited to the lesser of $2,000 or 100 percent of the employee's compensation, and is in lieu of the deduction allowed for contributions to an IRA.

[6] Employee contributions in excess of six percent of the employee's compensation are also taken into account under the overall limitations on contributions and benefits under qualified plans (described in Part III A).

contributions are required as a condition of obtaining additional employer-derived benefits).[7]

Special H.R. 10 rules

Under present law, an H.R. 10 plan which benefits an owner-employee may not provide for mandatory employee contributions (Treas. Reg. § 1.401–12(e)(1)). In addition, if an H.R. 10 plan benefits only owner-employees, nondeductible voluntary employee contributions are also precluded (sec. 4972). If an H.R. 10 plan benefitting owner-employees also benefits other employees, voluntary nondeductible contributions by an owner-employee are limited to the smallest of (1) $2,500, (2) 10 percent of the owner-employee's earned income from self-employment, or (3) the amount which would have been contributed by the owner-employee if such contribution were made at the rate of contributions permitted employees other than owner-employees.

Annual contributions on behalf of an owner-employee in excess of the combined limits on deductible and (if permitted) nondeductible contributions are subject to a six-percent nondeductible excise tax, unless the excess (plus earnings thereon) is withdrawn before the due date (including extensions) for filing the return for the taxable year.

Trustees of qualified plans

Present law generally does not preclude employees or officers of an employer from serving as trustees of a trust forming a part of the employer's qualified pension, etc., plan. However, with respect to an H.R. 10 plan which benefits an owner-employee, present law requires that the trustee be a bank or other financial institution approved by the Secretary of the Treasury (sec. 401(d)(1)).

Aggregation of employers

In general

For purposes of the qualification rules for pension, etc., plans, all employees of corporations which are members of a controlled group of corporations, or all employees of trades or businesses (whether or not incorporated) which are under common control, are aggregated and treated as if employed by a single employer (sec. 414(b) and (c)). In addition, special aggregation rules also apply with respect to the employees of certain service organizations and related employers (sec. 414(m)).

Special H.R. 10 rules

Under additional rules applicable to an H.R. 10 plan which benefits an owner-employee (or owner-employees), all employees of all unincorporated trades or businesses controlled by the owner-employee (or owner-employees) are treated as if employed by a single trade or business for purposes of the H.R. 10 qualification rules (sec. 401(d)(9) and (10)). An owner-employee, or two or more owner-employees, are considered to control an unincorporated trade or business if, alone or together, they own more than 50 percent of either the capital or profit interest in such trade or business.

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[7] The Service's position was announced in Rev. Rul. 80–307, 1980–2 C.B. 136, which superseded Rev. Rul. 72–58, 1972–1 C.B. 111. The earlier Revenue Ruling provided that, as a general rule, contributions required at a rate of six percent of compensation would not be considered burdensome on lower paid employees. The six-percent guideline was not renewed in Rev. Rul. 80–307.

Employer-provided life, health, and accident insurance

Under present law, the first $5,000 paid by or on behalf of an employer by reason of an employee's death generally is excluded from the income of the employee's beneficiaries or estate, if certain requirements are met (sec. 101(b)). This income exclusion for employer-provided death benefits may also generally be applied to the first $5,000 received by an employee's beneficiaries or estate as a lump sum distribution under a qualified pension, etc., plan. However, no income exclusion for employer-provided death benefits is available with respect to amounts paid on behalf of a self-employed individual, including amounts paid as a lump sum distribution under an H.R. 10 plan.

Amounts contributed by an employer to a qualified pension, etc., plan to provide incidental life, health, or accident insurance to employees covered by the plan generally are deductible when made. However, no deduction is allowed for contributions to an H.R. 10 plan on behalf of a self-employed individual to the extent that the contributions are allocable to the purchase of such insurance (sec. 404(a)(8)).

Under present law, an amount applied under a qualified pension, etc., plan to purchase life insurance protection for a participant is includible in the participant's income for the taxable year when so applied (sec. 72(m)(3)). Amounts so included in a participant's income generally are treated as amounts contributed by the participant under the plan, and may be recovered, tax-free, when benefits are paid under the plan (sec. 72(m)(2)). However, this rule for the tax-free recovery of amounts applied to purchase current life insurance protection does not apply to amounts applied under an H.R. 10 plan to purchase such protection for a self-employed individual.[8]

Explanation of Provisions

H.R. 10 plans

The bill would increase from $15,000 to $30,000 the deduction limit for contributions on behalf of a self-employed individual to an H.R. 10 defined contribution plan. The 15-percent of earnings limit would not be changed. A corresponding revision would increase permitted accruals under a defined benefit H.R. 10 pension plan.

The bill would also extend to all H.R. 10 plans certain of the special plan qualification rules which, under present law, apply only to H.R. 10 plans which benefit an owner-employee. Under the bill, any plan benefiting any self-employed individual would qualify under the tax law only if the plan meets the special owner-employee rules relating to employee participation, vesting, distributions, contributions, and benefits.

Plans for certain professional service corporations

Under the bill, the special qualification rules for H.R. 10 plans (as revised by the bill) would also apply to plans of professional service

[8] Prior to the Economic Recovery Tax Act of 1981, the prohibition against the tax-free recovery of the cost of current life insurance protection applied only with respect to amounts paid on behalf of an owner-employee. The Act extended the rule to apply to amounts paid on behalf of all self-employed individuals under an H.R. 10 plan.

corporations. For purposes of these rules, any shareholder-employee of the corporation would be treated as a self-employed individual, and any shareholder employee whose ownership interest exceeds 10 percent would be treated as an owner-employee.

A pension, etc., plan of a corporate employer would be subject to the professional service corporation rules if the principal function of the corporation is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, athletics, or consulting.

Effective Dates

The provisions affecting H.R. 10 plans generally would apply to taxable years and plan years beginning after December 31, 1983. However, an employer could elect to apply these provisions beginning with the first taxable year and plan year beginning after December 31, 1982.

The provisions affecting pension, etc., plans of professional service corporations would apply to taxable years and plan years beginning after December 31, 1983.

E. Statutory Fringe Benefit Plans

(Sec. 7 of the Bill and Secs. 87, 105, 120, 124, 127, and 129 of the Code)

Present Law

Prohibited discrimination in fringe benefits

Present law generally excludes from an employee's income the cost of the first $50,000 of employer-provided group-term life insurance (sec. 79). Additional income exclusions for employer-provided fringe benefits apply to (1) accident or health plans (sec. 105), (2) prepaid legal services plans (sec. 120), (3) van pooling plans (sec. 124), (4) educational assistance programs (sec. 127), and (5) dependent care assistance programs (sec. 129). Except with respect to group-term life insurance and benefits received under an accident or health plan (other than a self-insured medical reimbursement plan (sec. 105(h))), the income exclusion generally does not apply to any covered employee unless the plan or program meets certain requirements prohibiting discrimination in favor of employees who are officers, shareholders, or highly compensated.

Under present law, separate rules prohibiting discrimination are provided for each type of benefit plan or program. These rules generally prohibit discrimination as to eligibility to participate. A plan or program generally is required to meet the eligibility requirement by covering a classification of employees determined by the Internal Revenue Service not to result in prohibited discrimination. A self-insured medical reimbursement plan may also satisfy the requirement by covering a stated percentage of the employer's employees. The eligibility rules for the separate plans and programs generally permit employees covered by a collective bargaining agreement to be excluded from consideration, if the benefits provided by the plan or program were the subject of good faith bargaining between the employer and employee representatives. The eligibility rules for self-insured medical reimbursement plans also provide that employees who (1) have not completed 3 years of service, (2) have not attained age 25, or (3) are part-time or seasonable employees need not be taken into account.

The present-law antidiscrimination rules for some of the plans and programs also prohibit discrimination as to contributions or benefits. With respect to self-insured medical reimbursement plans,, present law specifically requires that all benefits available to officers, etc., also be available to all other plan participants.

The antidiscrimination rules for the separate plans and programs generally do not provide guidance as to when an employee is considered highly compensated, or the extent of stock ownership required before an employee is considered a shareholder. However, for

self-insured medical reimbursement plans, the group of employees in whose favor discrimination is prohibited is defined as including (1) the 5 highest paid officers, (2) shareholders owning more than 10 percent of the value of the employee's stock, and (3) the highest paid 25 percent of all employees (determined by excluding those employees not required to be taken into account under the eligibility rules).

Under present law, if a plan is determined to discriminate in favor of employees who are officers, shareholders, or highly compensated, the otherwise applicable income exclusion generally is denied for all benefits provided under the plan, including those benefits provided for rank-and-file employees. However, under a discriminatory self-insured medical reimbursement plan, only those employees with respect to whom discrimination is prohibited are required to include amounts in gross income. Other employees retain the benefit of the income exclusion.

Additional limitations

The present-law rules relating to (1) prepaid legal services plans, (2) educational assistance programs, and (3) dependent care assistance programs include limits on the proportion of total benefits which may be provided by the employer for the group of individuals who are shareholders or owners, or their spouses or dependents. These limits are in addition to the separate antidiscrimination rules also applicable to the plan or program.

Cafeteria plans

Under a cafeteria plan, an employee may choose from a package of employer-provided fringe benefits, some of which may be taxable (*e.g.*, group-term life insurance in excess of $50,000) and some of which may be nontaxable (*e.g.*, health and accident insurance). Under present law, employer contributions under a cafeteria plan which permits employees to elect between taxable and nontaxable benefits generally are excluded from the income of an employee to the extent that nontaxable benefits are elected (sec. 125). However, the income exclusion will apply only if the cafeteria plan satisfies special antidiscrimination rules with respect to employee eligibility to participate and to the availability of contributions or benefits under the plan.

Self-employed individuals

Under present law, the income exclusions for (1) group-term life insurance, (2) accident or health plans, (3) van pooling plans, and (4) cafeteria plans do not apply with respect to self-employed individuals (sole proprietors or partners). However, an income exclusion is provided self-employed individuals for contributions and benefits under (1) prepaid legal services plans, (2) educational assistance programs, and (3) dependent care assistance programs.

Explanation of Provision

The bill would repeal the separate antidiscrimination rules now applicable to (1) self-insured medical reimbursement plans, (2) prepaid legal services plans, (3) van pooling plans, (4) educational as-

sistance programs, and (5) dependent care assistance programs. The bill would substitute uniform rules which would apply to all such plans and programs, to employer-provided group-term life insurance, and to accident or health plans (defined in the bill as statutory fringe benefit plans).

Under the bill, if a statutory fringe benefit plan discriminates in favor of the employer's key employees, benefits provided key employees under the plan would be allocated to them and would be included in their gross income. Benefits provided employees who are not key employees would remain eligible for the applicable present-law income exclusion.

For purposes of the antidiscrimination rules, key employees would be those defined as key employees under the bill's provision relating to loans from qualified pension, etc., plans (described above at Part III.B.). Accordingly, key employees generally would include (1) officers, (2) those owning at least 5 percent of the employer, and (3) those among the highest paid 15 percent of the employer's employees. Under the fringe benefit rules, an individual would be considered a key employee for a plan year if the individual is a key employee on the first day of the plan year (or on the date the individual first becomes a plan participant, if later), or if the individual was a key employee on any day during the preceding plan year.

Under the bill, a discriminatory statutory fringe benefit plan would be one which discriminates in favor of key employees as to eligibility to participate or as to the type and amount of benefits available under the plan. The extent to which key employees, relative to other employees, actually utilize plan benefits would not be taken into account under the bill's antidiscrimination rules.

A statutory fringe benefit plan would not be considered to discriminate in favor of key employees as to eligibility to participate if (1) the plan benefits at least 70 percent of all employees, (2) at least 85 percent of all participating employees are not key employees, or (3) the plan benefits employees who qualify under a classification set up by the employer and found by the Secretary of the Treasury not to discriminate in favor of key employees. In applying these and other tests under the bill, employees of certain related employers would generally be treated as if employed by a single employer. For purposes of these rules, however, the following employees could be excluded from consideration: (1) those who have not completed 3 years of service with the employer, (2) part-time and seasonal employees, and (3) nonresident aliens who receive no U.S. source income from the employer. In addition, the bill provides that employees not covered by the plan but covered by a collective bargaining agreement need not be taken into account if the benefits provided under the plan were the subject of good faith bargaining between the employer and employee representatives.

The bill provides that a statutory fringe benefit plan would be discriminatory with respect to the benefits available under the plan unless all benefits available to participating key employees are also available to all other participating employees. Under a special rule, however, a group-term life insurance plan would not be considered discriminatory merely because the amount of life insurance provided employees bears a uniform relationship to compensation.

In the case of a discriminatory statutory fringe benefit plan, the bill provides that the portion of the employer's total cost for the plan year which is attributable to benefits provided with respect to key employees and is not otherwise includible in their gross income generally would be allocated pro rata among the key employees. The amount so allocated to a key employee would be includible in gross income for the key employee's taxable year within which or with which the plan year ends. An employer could provide for other than a pro rata allocation among key employees, subject to a determination by the Secretary of the Treasury that the employer's allocation method is reasonable.

The bill does not revise the present-law rules limiting amounts which may be provided under a (1) prepaid legal services plan, (2) educational assistance program, or (3) dependent care assistance program for the class of plan beneficiaries consisting of owners, their spouses and dependents. In addition, the bill does not revise the present-law antidiscrimination rules for cafeteria plans, or those rules under which certain of the income exclusions for employer-provided fringe benefits are not available to self-employed individuals.

Effective Date

The provisions of the bill relating to statutory fringe benefit plans would apply to plan years ending after December 31, 1983.

F. Estate Tax Exclusion for Retirement Savings (Sec. 8 of the Bill and Sec. 2039 of the Code)

Present Law

Benefits payable to a beneficiary (other than the executor) of a deceased employee under a qualified pension, etc., plan or a tax-sheltered annuity program generally are excluded from the decedent's estate except to the extent attributable to nondeductible employee contributions made by the decedent (sec. 2039(c)). The estate tax exclusion also applies to benefits payable under Federal law to survivors of retired servicemen.

Under present law, the estate tax exclusion does not apply to benefits payable under a qualified plan as a lump sum distribution unless the beneficiary elects to forego the 10-year income averaging and long-term capital gain treatment otherwise applicable to the distribution under the income tax rules (sec. 2039(f)). Also, with respect to a tax-sheltered annuity, the estate tax exclusion does not apply to benefits attributable to amounts paid for the contract by an employer which is a private foundation.

Present law also excludes from a decedent's gross estate amounts payable to a beneficiary (other than the executor) under an individual retirement account, annuity, or bond (IRA). The exclusion is limited to amounts attributable to deductible annual contributions or to qualifying rollover contributions. However, the exclusion does not apply to amounts in the IRA that are attributable to a rollover contribution of (1) an amount paid to the surviving spouse of an employee under a qualified plan or tax-sheltered annuity, or (2) amounts paid for a tax-sheltered annuity by an employer which is a private foundation. In addition, the estate tax exclusion applies only where amounts in the IRA are payable to the beneficiary in substantially equal, periodic payments extending over a period ending at least 3 years after the decedent's death.

Explanation of Provision

The bill would impose an aggregate $500,000 limit on the estate tax exclusion for amounts payable with respect to a decedent under (1) a qualified pension, etc., plan, (2) a tax-sheltered annuity program, (3) the retired servicemen's survivor benefit plan, or (4) an IRA.

Effective Date

The provision would apply to estates of decedents dying after December 31, 1982.

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